India: Interest rate hikes are not the solution

Economists

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- The sharp rupee depreciation has led to market concern about a rate hike as a possible policy response. The rationale for a rate hike to stem currency depreciation is simple: slow aggregate demand and attract more capital flows.
- In our view, this standard theory is not applicable to India's current macroeconomic landscape for three reasons: the problem is lack of supply; flows are likely more growth-sensitive; and domestic demand has already collapsed.
- A rate hike is being mooted because of attempts to peg the currency. In our view, given limited FX reserves (making strong intervention impossible) and a dismal growth outlook (making a hike difficult), the RBI should let the currency gradually adjust.
- Rate hikes are not the solution, in our view. We think the ideal response would be to let the currency gradually depreciate, but tighten fiscal policy and continue supply-side reforms. The ball is in the government's court.

The sharp rupee depreciation has led to market concern about a rate hike as a possible policy response. Indeed, some EM countries have recently raised interest rates to defend their currencies. The rationale for a rate hike to stem currency depreciation is simple. A worsening current account balance is symptomatic of an overheated economy, where aggregate demand needs to be contained. Additionally, higher relative interest rates can attract more capital inflows helping to balance the balance of payment.

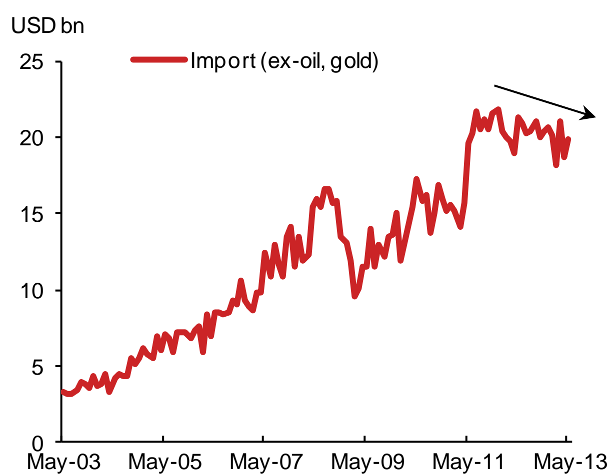
In our view, this standard theory is not applicable to India's current macroeconomic landscape. First, in India the problem is not one of containing aggregate demand; rather it is lack of supply. Second, it is debatable whether capital flows into India are growth-sensitive or interest-rate-sensitive. The predominant share of portfolio equity flow in the capital account suggests flows are likely more growth-sensitive. Third, domestic demand has already collapsed. Non-oil/non-gold components of imports have been flat to declining for some time now, indicating weak private demand (Figure 1). Given rising domestic leverage on corporate balance sheets (particularly in construction, infrastructure developers, power generation, telecom and metals) and their inter-linkage with banks (high non-performing loans and restructured assets), the cost of hiking interest rates at this juncture could do more harm than good, in our view.

The possibility of rate hike is being considered because of attempts to peg the currency at a certain level. The theory of the impossible trinity says that a country can have only two of the following three: an open capital account, a fixed exchange rate and an independent monetary policy. Given a low risk of capital controls, the option for the RBI is between letting the currency adjust or losing control over its monetary policy. In our view, given limited FX reserves (the RBI can't intervene aggressively due to falling FX reserve cover; Figure 2) and a dismal domestic growth outlook (it can't hike either), the RBI should let the currency adjust gradually (*USD/INR: Remain long USD, but watchful of potential measures*, 26 June 2013).

Rate hikes are not the solution in our view. As we have argued before, a weak rupee is negative for India's growth in the short run (*INR depreciation: Macro impact and policy response*, 11 June 2013). The competitive gains of INR depreciation are limited given India's supply-side bottlenecks, while there are negative effects from higher imported inflation, delayed rate cuts, high asset price volatility and the increased cost of foreign currency debt. In fact, by delaying rate cuts and keeping liquidity tight despite weak growth and falling CPI inflation, as is likely, monetary policy would automatically be slightly restrictive.

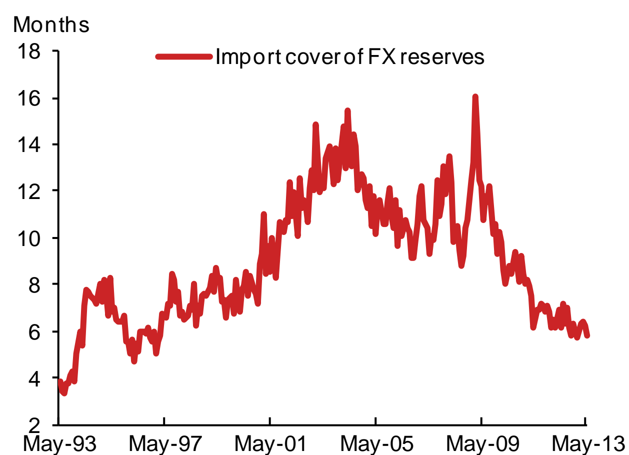
We see the root of India's problems to be lack of structural reforms, including fiscal, and INR depreciation is the by-product of that. We think the ideal response would be to let the currency gradually depreciate, but tighten fiscal policy and continue supply-side reforms. A prudent fiscal policy along with structural reforms would contain consumption demand, ease investment bottlenecks, lower inflationary pressures and, after a while, create the conditions that would allow the RBI to focus on growth. Government spending is budgeted to rise 16.4% y-o-y this year and the Food Security Bill is being prepared. This is a pre-election year, but the economy cannot afford this at the moment. The ball is in the government's court.

Fig. 1: Imports (excluding oil and gold)



Source: CEIC and Nomura Global Economics.

Fig. 2: Months of import cover



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